Credit Risk Management and Credit Risk Matrix

Recently banks in many countries have been engaged with a procedure of redesigning their risk management capabilities. The rapid development and expanding complication of the financial related market along with increasing competitor, have been significant reasons for the upgradation of the risk management. The various risk faced by banks is credit risk, interest rate risk in the banking book and operational risk. Among three of it, the credit risk is considered the biggest risk faced by the banks. However, the credit cycles in the bank cannot be omitted but the credit risk associated with it can be closely examined and analyzed.

Taking in the account for the importance of credit risk management in the banking sector, we decided to prepare our group presentation on credit risk management for one of the banking services in our home country, called Bank of Bhutan (BoB). Bank of Bhutan was established by a Royal Charter in May 1968, and it is the oldest and largest bank in the country, providing its services in every district and major township of Bhutan. BoB delivers a widespread range of financial products and services, such as loans, deposits, money market and trade finance. To elaborate on credit services offered by BoB, they are a personal loan, education loan, construction loan, agricultural loan, commercial loan, vehicle loan, etc.

To understand the risk context, the Bank of Bhutan consists of the Board of Directors who are entrusted with the ultimate responsibility for guiding the strategic direction and performance of BoB to achieve the targets. The BoB Board consists of seven Directors, including the Chairman and the Chief Executive Officer. The management of BoB is headed by the Chief Executive Officer (CEO) for the management of day to day affairs of the Company. There are also other committees like Board Credit Committee, which was established to make the decision on Credit related issues having beyond the authority of the management and The Board Risk Management Committee was established to monitor the key risk indicators of the Bank besides making the decision on risk-related issues and activities. The stakeholders of the Bank of Bhutan consist of customers, suppliers, employees, investors, and shareholders.

The Risk Management Framework of BoB is an exposition of the Bank's approach to Risk Management and seeks to put in place comprehensive monitoring, management and reporting framework that allows risks to be identified, managed and overseen in a timely and efficient manner. The framework also seeks to set up systems and procedures to actively mitigate associated risks and optimize resources not only to protect the Bank but also to provide a return commensurate with the risk profiles adopted. The framework is administered by various risk management policies, activities, and exercises, which are updated to the management and the board periodically. Credit risk management of BoB can be defined as the practice of mitigating losses by understanding the bank's capital adequacy and loan loss reserves at any point in time. The main goal is to increase the risk-adjusted rate of return by continuing credit risk exposure within acceptable parameters.

Credit risk identification is been carried out by brainstorming session, checklist, reviewing report, looking at the historical data. They also investigate Track Record, Credibility, Payment records, and others. Most of the common cause of credit risk are Asset loan quality, Asset liability mismatch, Fraud, and Backdated Credit Risk Management Policy. For Asset loan quality, it is

found that if the quality of the loan is not good then it can be very risky for the bank. The loan is the asset for the bank, but the loan which is taken by any people or organization is not repaid within due time this can result in the loan to be a bad asset. That is why banks check the creditworthiness of the person or organization before giving a loan.

Risk Analysis and Evaluation can be carried out by adopting a Credit score rating, where there will be three-digit number and must keep eyes on the very first credit transaction. It helps in analyzing by traced and tracked on the payment history, credit utilization, cash transactions, tax issues, credit score inquires. The trustworthiness of a lender is rated as below:

- Excellent credit: credit scores above 800
- Very good credit: credit scores between 750 and 800
- Good credit: credit scores between 700 and 750
- Fair credit: credit scores between 650 and 700
- Bad credit: credit scores between 600 and 650
- Very bad credit: credit scores below 600

A credit risk matrix can also be used to tags a client's account of the risk portfolio. When these individual risk profiles are aggregated, an overall idea of the credit risk profile of the receivable's portfolio. It brings up the advantages of being comprehensive, compels the development of risk mitigation plans appropriate for each of the risk profiles and tracks changes of receivables over time. The following credit risk matrix can be constructed with Financial Position and Payment Habit as bases.

The following conclusion can be derived from the credit risk matrix:

- Quadrant 1 (Exemplars) – Vigorous financial related position being combined with timely instalment payment habit. This is a perfect credit risk profile. Customers who have a place with this group are not a great deal, consequently, there is a need to apply most extreme exertion to retain those ones.
- Quadrant 2 (Scrooges) – Vigorous financial related position but with habits of slow payment. There will be trouble while collecting payment from those customers and it is not due to, they don't have any means to do so. Meant for this group, it is vital to recognize their payment processes and bring into line the collection process to theirs. Hence, having a good relationship with the customer is a benefit to the bank.
- Quadrant 3 (Supporters) – Punctual payment habit but weak financial position. They may not good income, but they are interested to clear their debts. As their monetary position is so good, it's significant to keep track of their operations and notice signs that indicate any decline to their financial position.
- Quadrant 4 (Toughies) – Slow payment habit with a weak financial position. These customer does not make a good client for credit; therefore, the bank should be very careful while dealing with such clients. The best thing to do is to have a bond or security in place which will be helpful, as does setting strict credit limits.

Bob also adopts an approach called 5 Cs to minimize the risk by data mining of the clients regarding the loan sanction. The factors of 5 Cs are as follows:

- Capital (Borrower’s risk-bearing commitment)
- Capacity (to provide adequate cash flows)

- Collateral (Priority of charge and value)
- Character (of Borrower)
- Condition- (of business of borrower)

Risk Monitoring can be followed in accordance with the prudential norms prescribed by the Royal Monetary Authority of Bhutan for single borrowers and for group borrowers. Further, there are substantial exposures prescribed by the Loan policy for Single borrowers and Group borrowers. Risk monitoring can be done also by reviewing the report submitted to the board by the Board Risk Management Committee.

Risk treatment has various methods like placing sound lending policy and loan appraisal systems. Guarantees/collateral can be nominated as risk mitigators too, followed by proper documentation, supervision, follow-up, and monitoring of advances. Loan Review Mechanism can also play a vital role in risk treatment.

To conclude, better credit risk management offers an opportunity to significantly improve overall performance and secure a competitive advantage in this global economic scenario. Better credit risk management decreases financial risk and generates revenue for the Bank, which raises the Bank's profitability and once the bank is in a good state, the country's economy is also growing strong and adds to the GDP of the country. So, there is a symbiotic relationship. Therefore, effective ways of risk management have gained importance. The chief goal of effective credit risk management must be to maintain the key components of best practices that are followed worldwide and adopted universally.

References:

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